IN THE

Supreme Court of the United States

October Term, 1942.

No. 303

GUY T. HELVERING, Commissioner of Internal Revenue,
Petitioner,

v.

AMERICAN DENTAL COMPANY.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

SUPPLEMENT TO RESPONDENT'S BRIEF.

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INDEX

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In support of the point, made on page 19 of respondent's brief, that there was no forgiveness of either rent or interest in the case at bar unless by gift we direct this court's attention to Williston on Contracts, Revised Edition, Volume 1, page 415, section 120 and to note 3 thereof, wherein many cases are collected including a decision of

this court and several decisions of the Supreme Court of Illinois.

The lease was an Illinois contract embracing Illinois real estate. Under Illinois law the promise to forgive the rent was "a mere *nudum pactum*" (*Loach* v. *Farnum*, 90 Ill. 368), and if it did not amount to a gift then there has been no valid forgiveness of rent in the case at bar. *Levy* v. *Greenberg*, 261 Ill. App. 541, and cases therein cited. The court's attention is also called to *McKenzie* v. *Harrison*, 120 N. Y. 260, 265, 266, which sustained an analogous rent reduction as a gift.

The same principle of law applies to the forgiveness of interest in the case at bar.

If the court affirms the holding of the Circuit Court of Appeals that the forgiveness was a gift that ends the case. If the court concludes otherwise then it must decide whether there was any legal forgiveness of debt and if so by what legal means. If it concludes there was no legal forgiveness of debt there in no question of income and the decision below must be affirmed.

Only if the court resolves both of the above questions against respondent will it be necessary to consider the argument, made at pages 20 to 23 of our brief, that the forgiveness of debt was not taxable income under section 22 (a) as construed in *Bowers* v. *Kerbaugh Empire Co.*, 271 U. S. 170. As stated by petitioner, on page 6 of his petition for the writ, he rests his argument in this respect on the *Kirby Lumber Co.* and *Maryland Casualty Co.* cases. The *Kirby Co.* case is discussed at pages 4 and 5 of our main brief.

The sentence in the regulation, quoted on page 21 of petitioner's brief, which reads "a taxpayer realizes income by the payment or purchase of his obligations at less than their face value" states an invalid rule unless it be qualified by article 22 (a) (18) to which it refers. Suppose one issues his $100 note to a loan shark for $90 cash and later settles it for $90. He certainly has not realized $10 income. As aptly said by the Circuit Court of Appeals for the second circuit (quoted on page 21 of our main brief) "the consideration received for the obligation evidenced by the bonds as well as the consideration paid to satisfy that obligation must be looked to in order to determine whether gain or loss is realized when the transaction is closed." The face value of the obligation may be disregarded. Here taxpayer received the right to use floor space which had depreciated in value during 1932 and 1933 so that it was worth no more than taxpayer eventually paid for it. It never received any money or property for the interest or the rent forgiven. So the items were not income.

On this question it is also necessary to consider the *Maryland Casualty Co.* case in connection with the point, made at pages 10 and 11 of petitioner's brief, concerning the effect of the deduction of the items by respondent in prior years. In addition to what is said on pages 25 to 27 of our brief we submit the following for the consideration of the court.

Petitioner candidly admits at the bottom of page 10 and top of page 11 of his brief that this court has never squarely ruled on the point. Nevertheless the decisions of the lower courts, collected in note 8 on page 10 of petitioner's brief, all proceed on the assumption that this court did so in *Maryland Casualty Co. v. United States*, 251 U. S. 342, 352 (cited and relied on at page 11 of petitioner's brief).

That case merely construed a special provision of the 1913 Act taxing insurance and laid down no such unjust and startling principle as some lower courts have (all without thorough examination of the case) erroneously assumed.

The government's brief on *Maryland Casualty Co.* v. *United States*, 251 U. S. 342, states this phase of the case as follows (pp. 43, 44 thereof):

> "During the year 1913 there was a large decrease in the reserve fund for unpaid liability losses. In its original return the appellant treated the amount of the decrease as an increase in income, and the Commissioner so treated it in making the final assessment. * * * This money, it is true, had been received prior to 1913, but because it was required to be kept in reserve Congress has seen fit to enact that it should not be treated as received as taxable income. When it was released from the reserve fund it assumed, for the first time, the status of other income of the company and can fairly be said to have been for the first time received as income. Giving the most liberal construction to the action of Congress, it cannot be inferred that it ever intended any income of an insurance company should escape taxation except so long as it was required by law to be held in reserve. It is therefore submitted that when in 1913 it was no longer required for this purpose it was then, for the first time received as income and became taxable as part of the income for that year."

That the basis of this court's decision was the peculiar statutory provisions, which set up a special method for taxing insurance companies appears from the following statement in the opinion (251 U. S., at p. 352):

> "If, in this case, it were due to an overestimate of reserves for 1912 with a resulting excessive deduction for that year from gross income and if such ex-

cess was released to the general uses of the company and increased its free assets in 1913, to that extent it should very properly be treated as income in the year it became so available, *for the reason that, in that year for the first time, it became free income under the system for determining net income provided by the statute* and the fact that it came into possession of the company in an earlier year in which it could be used only in a special manner, which permitted it to become nontaxable would not prevent it being considered as received in 1913 for purposes of taxation, *within the meaning of the act*." (Italics ours.)

From 1909 to 1913 the rate of tax on corporate income was the flat rate of 1 per cent. It made no difference in which year an item was taxable income when the tax rate was constant. The *Maryland Casualty* case was never intended to stand for the ridiculous principle that if a taxpayer saved $10,000 tax by $1,000,000 deductions from 1909 to 1913 if it chanced to recover the $1,000,000 in 1942 it would have to pay $900,000 in tax although if it had not taken the $1,000,000 in deductions from 1909 to 1913 the item would concededly not be 1942 income. There is not a line in the statute which says that deductions in an earlier year may create income in a later year and it is submitted Congress would not enact such a statute. The hardship and injustice of examples such as that above given and to which the decisions collected in note 8 on page 10 of petitioner's brief might and did lead was intended to be prevented by section 3801 (discussed at pages 25 and 26 of our main brief) which was first enacted in the Revenue Act of 1938 for this express purpose.

These cases rest on a theory akin to equitable estoppel, *i.e.*, that it is inequitable for a taxpayer to retain the benefit of the deduction and exclude the deduction (re-

covered in cash in those cases) from income in the year of recovery. This is pointed out in *E. B. Elliott Co.*, 45 B. T. A. 82, at pages 89 to 92, wherein the Board held them inapplicable if the year of deduction was still open. In the case at bar not only section 3801 but our tender of the tax saved by the deduction, either or both preclude the application of this principle which even where, if ever, applicable, produces tax distortion.

All of which is respectfully submitted,

John E. Hughes,
James A. O'Callaghan,
Counsel for Respondent.

SUPREME COURT OF THE UNITED STATES.

No. 303.—October Term, 1942.

Guy T. Helvering, Commissioner of Internal Revenue, Petitioner, *vs.* American Dental Co.	On Writ of Certiorari to the United States Circuit Court of Appeals for the Seventh Circuit.

[March 1, 1943.]

Mr. Justice Reed delivered the opinion of the Court.

This writ of certiorari brings here for review the question of the taxability, as income, of rent and interest on accounts owed by the taxpayer which were cancelled by its creditors.

The taxpayer, a corporation, respondent here, owed certain past due bills for merchandise. This indebtedness was represented by interest bearing notes. Interest upon these notes had been accrued for the years prior to 1937 and deducted in the taxpayer's income tax returns, to the amount of $11,435.22. In November, 1936, the creditors agreed to cancel all interest accruing after January 1, 1932. The first entry on the taxpayer's books which records the cancellation appears in December, 1937, the tax year here involved, when over $16,000 was credited.

The taxpayer in December, 1933, also owed back rent amounting to $15,298.99. This back rent had been accrued as an expense. A new lease was negotiated at that time and the lessor promised to make an adjustment of the accumulated obligation. The following April the lessor advised the taxpayer that he would accept $7500 in payment of the back rent and would cancel the rest. The reduced sum was paid in February, 1937, by cash and notes which were met the same year. In 1937 the first entries were made on both the lessor's and the taxpayer's books, showing the partial forgiveness of the back rent.

The date of the book entries of the cancellations and the deduction of the interest for the whole of 1936 by the taxpayer led the Board of Tax Appeals to uphold the Commissioner's determination that the cancellation of all items of indebtedness involved here took place in 1937. This determination is accepted by us. *Wilmington Trust Co.* v. *Commissioner*, 316 U. S. 164, 168.

The taxpayer credited the total amount of the cancelled debts, $25,219.65 to earned surplus.[1] It did not return any of the sum as taxable income. No proof appears of the insolvency of the taxpayer before or after the cancellation. Its balance sheets show assets exceeding liabilities at the opening and close of 1937 with net assets greater than the asserted adjustment of income. Under these circumstances the Commissioner increased the taxpayer's reported income by $19,234.21, the sum of the items of the cancelled indebtedness which the Board of Tax Appeals found had served to offset income in like amounts in prior years. The taxpayer had accrued the rent and interest in former years. No claim for additional taxes is made by the Commissioner.

The taxpayer sought a redetermination on the ground that the cancellations were exempt gifts and that it was not enriched beyond the tax advantages gained by the deductions in former tax returns. The Board of Tax Appeals found that the cancellations were not gifts, concluded that the tax benefits in dollars obtained by the deductions of former years did not limit the 1937 tax springing from the cancellation and affirmed the Commissioner's determination of a deficiency. The Court of Appeals reversed on the ground that the cancellations constituted exempt gifts. On account of a variety of views in the circuits as to the taxability of similar adjustments of indebtedness, we granted certiorari.[2] — U. S. —.

The applicable statutory provisions are Section 22(a) and (b)(3) of the Revenue Act of 1936.[3] The general definition of

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[1] There is an unexplained and immaterial variance between the sum of the items cancelled and the total credited to surplus.

[2] Dallas T. & T. Warehouse Co. v. Commissioner, 70 F. 2d 95; Commissioner v. Coastwise Transp. Corp., 71 F. 2d 104; Hirsch v. Commissioner, 115 F. 2d 656; Helvering v. A. L. Killian Co., 128 F. 2d 433; Haden Co. v. Commissioner, 118 F. 2d 285.

[3] 49 Stat. 1648, 1657, Sec. 22, Gross income:

"(a) *General Definition.*—'Gross income' includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. . . . .

"(b) *Exclusions from Gross Income.*—The following items shall not be included in gross income and shall be exempt under this title:

. . . .

"(3) *Gifts, Bequests, and Devises.*—The value of property acquired by gift, bequest, devise, or inheritance (but the income from such property shall be included in gross income); . . ."

gross income has varied little in the successive revenue acts, and, from the earliest, gifts have been excluded by substantially identical statutory language. Act of October 3, 1913, 38 Stat. 166. The Treasury Department Regulations 94, relating to the Revenue Act of 1936, Art. 22(a) 14, covered cancellation of indebtedness.[4] This regulation first appeared in Regulations 86 under the 1934 Act. It marked a change in the Treasury's concept of the tax effect of debt forgiveness. The old article as it appeared in Regulations 77, relating to the 1932 act, read in part:

"If, however, a creditor merely desires to benefit a debtor and without any consideration therefor cancels the debt, the amount of the debt is a gift from the creditor to the debtor and need not be included in the latter's gross income."[5]

The same language appeared in the former Regulations.[6]

In fields closely related to the cancellation of indebtedness which we are considering here, this Court has treated gains in net assets as income. In *United States* v. *Kirby Lumber Co.*, 284 U. S. 1, the taxpayer purchased its own bonds at a discount. It

[4] "Art. 22(a)-14. Cancellation of indebtedness.—The cancellation of indebtedness, in whole or in part, may result in the realization of income. If, for example, an individual performs services for a creditor, who in consideration thereof cancels the debt, income in the amount of the debt is realized by the debtor as compensation for his services. A taxpayer realizes income by the payment or purchase of his obligations at less than their face value. (See article 22(a)-18.) If a shareholder in a corporation which is indebted to him gratuitously forgives the debt, the transaction amounts to a contribution to the capital of the corporation. Income is not realized by a taxpayer by virtue of the discharge of his indebtedness as the result of an adjudication in bankruptcy, or by virtue of a composition agreement among his creditors, if immediately thereafter the taxpayer's liabilities exceed the value of his assets."

The article relating to the exclusion of gifts from gross income is not helpful. It merely says gifts are exempt from the income tax. Art. 22(b)(3)-1.

[5] The whole article was as follows:

"Art. 64. Forgiveness of indebtedness.—The cancellation and forgiveness of indebtedness may amount to a payment of income, to a gift, or to a capital transaction, dependent upon the circumstances. If, for example, an individual performs services for a creditor, who in consideration thereof cancels the debt, income to that amount is realized by the debtor as compensation for his services. If, however, a creditor merely desires to benefit a debtor and without any consideration therefor cancels the debt, the amount of the debt is a gift from the creditor to the debtor and need not be included in the latter's gross income. If a shareholder in a corporation which is indebted to him gratuitously forgives the debt, the transaction amounts to a contribution to the capital of the corporation."

[6] Regulations 74, Art. 64 (1931); Regulations 69, Art. 49 (1926); Regulations 65, Art. 49 (1924), for individuals; Regulations 62, Art. 50 (1922), for individuals; Regulations 45 (1920 ed.), Art. 51, for individuals.

When the gift tax was revived in 1932, the House Report gave as an example of a gift "the forgiveness or payment by A of B's indebtedness." H. Rep. No. 708, 72nd Cong., 1st Sess., p. 28(5).

was held taxable on the increase in net assets which resulted.[7] This holding was confirmed by *Helvering* v. *American Chicle Co.*, 291 U. S. 426. See also *Commissioner* v. *Coastwise Transp. Corp.*, 71 F. 2d 104. Forfeiture or surrender of a lease by which the lessor gains property or money makes such gain taxable. *Helvering* v. *Bruun*, 309 U. S. 461; *Hort* v. *Commissioner*, 313 U. S. 28. The narrow line between taxable bonuses and tax free gifts is illuminated by *Bogardus* v. *Commissioner*, 302 U. S. 34, on the one side and upon the other by *Noel* v. *Parrott*, 15 F. 2d 669, as approved in *Old Colony Trust Co.* v. *Commissioner*, 279 U. S. 716, 730.

Normally cancellations of indebtedness occur only when the beneficiary is insolvent or at least in financial straits. Possibly because it seems beyond the legislative purpose to exact income taxes for savings on debts, the courts have been astute to avoid taxing every balance sheet improvement brought about through a debt reduction. Where the indebtedness has represented the purchase price of property, a partial forgiveness has been treated as a readjustment of the contract rather than a gain. *Hirsch* v. *Commissioner*, 115 F. 2d 656; *Helvering* v. *A. L. Killian Co.*, 128 F. 2d 433; *Gehring Publishing Co., Inc.* v. *Commissioner*, 1 T. C. 345. Where a stockholder gratuitously forgives the corporation's debt to himself, the transaction has long been recognized by the Treasury as a contribution to the capital of the corporation. Regulations 45, Art. 51, through to Regulations 94, Art. 22(a)-14. *Commissioner* v. *Auto Strop Safety Razor Co., Inc.*, 74 F. 2d 226.[8]

The uncertainties of the effect of the remission of indebtedness on income tax brought about legislation to clarify the problems. The Chandler Bankruptcy Act of June 22, 1938, instituted adjustments deemed desirable.[9] The provision of Chapter X of the bankruptcy act relating to corporate reorganizations are typical. They declare that no income should be recognized "in respect to

[7] The fact that the purchase was made in the taxable year of issue is immaterial. Burnet v. Sanford & Brooks Co., 282 U. S. 359, 364, 365; Commissioner v. Norfolk Southern R. Co., 63 F. 2d 304.

[8] For discussions of the general problem see "The Revenue Act of 1939 and the Income Tax Treatment of Cancellation of Indebtedness," 49 Yale L. J. 1153; "Cancellation of Indebtedness and Its Tax Consequences," 40 Col. L. Rev. 1326; "Discharge of Indebtedness and the Federal Income Tax," 53 Harv. L. Rev. 977.

[9] Corporate reorganizations under Chap. X or 77B, §§ 268, 270, 276(c)(3), 52 Stat. 904, 905; arrangements under Chap. XI, §§ 395, 396, 52 Stat. 913; real property arrangements under Chap. XII, §§ 520, 521, 522, 52 Stat. 929; wage earners plans under Chap. XIII, § 679, 52 Stat. 938; railroad adjustments under Chap. XV, § 735, 53 Stat. 1140.

the adjustment of the indebtedness of a debtor" under reorganization proceedings, Section 268, 52 Stat. 904, provided that the basis of the property should be reduced correspondingly as specified in Section 270 as amended July 1, 1940, 54 Stat. 709. The basis requirements do not appear throughout the sections, e. g., Chapter XV. The Revenue Act of 1939[10] amended the Internal Revenue Code, Sections 22(b) and 113(b), so as to extend similar relief to all corporate taxpayers "in an unsound financial condition."[11]

It was provided that Section 215 should not apply to any discharge of indebtedness occurring prior to the enactment of the Revenue Act of 1939. No further explanation for this limitation appears beyond the language of the House Report:

"The amendments made by section 215 of the bill are applicable only to taxable years beginning after December 31, 1938. They are not applicable to discharges of corporate indebtedness occurring prior to the date of the enactment of the bill. They are also not applicable to a discharge occurring in any taxable year beginning after December 31, 1942. They likewise do not apply to any discharge of corporate indebtedness occurring in any proceeding under section 77B, or under chapter X or XI, of the Bankruptcy Act of 1898, as amended, since such discharges are governed by other provisions of law." P. 25.

The Revenue Act of 1942, 56 Stat. —, Section 114, amended Section 22(b)(9) of the Internal Revenue Code so as to make the exclusion from gross income of income arising from discharge of indebtedness applicable generally to all corporations, whether or not financially sound.[12]

In the light of these views upon gain, profit and income, we must construe the meaning of the statutory exemption of gifts from gross income by Section 22(b)(3). The broad import of gross income in Section 22(a)[13] admonishes us to be chary of extending any words of exemption beyond their plain meaning.

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[10] 53 Stat. 875, § 215.

[11] See S. Rep. No. 648, 76th Cong., 1st Sess., p. 5; H. Rep. No. 855, 76th Cong., 1st Sess., p. 23.

[12] See S. Rep. No. 1631, 77th Cong., 2d Sess., p. 77; 26 U. S. C. § 22:

"(b) Exclusions from gross income. The following items shall not be included in gross income and shall be exempt from taxation under this chapter:

. . . .

"(9) Income from discharge of indebtedness.—In the case of a corporation, the amount of any income of the taxpayer attributable to the discharge, within the taxable year, of any indebtedness of the taxpayer . . . evidenced by a security. . . . This paragraph shall not apply to any discharge occurring before the date of enactment of the Revenue Act of 1939, or in a taxable year beginning after December 31, 1945."

[13] Helvering v. Clifford, 309 U. S. 331, 334.

Cf. *Heiner* v. *Colonial Trust Co.*, 275 U. S. 232, 235; *United States* v. *Stewart*, 311 U. S. 60, 63. Gifts, however, is a generic word of broad connotation, taking coloration from the context of the particular statute in which it may appear. Its plain meaning in its present setting denotes, it seems to us, the receipt of financial advantages gratuitously.

The release of interest or the complete satisfaction of an indebtedness by partial payment by the voluntary act of the creditor is more akin to a reduction of sale price than to financial betterment through the purchase by a debtor of its bonds in an arms-length transaction. In this view, there is no substance in the Commissioner's differentiation between a solvent or insolvent corporation or the taxation of income to the extent of assets freed from the claims of creditors by a gratuitous cancellation of indebtedness. *Lakeland Grocery Co.* v. *Commissioner*, 36 B. T. A. 289. Cf. *Madison Railways Co.* v. *Commissioner*, 36 B. T. A. 1106; *Spokane Office Supply Co.* v. *Commissioner*, Docket No. 86762, memo. op. of April 29, 1939; *Model Laundry, Inc.* v. *Commissioner*, Docket No. 93493; memo. op. of January 15, 1940. See also *Haden Co.* v. *Commissioner*, 118 F. 2d 285, which supports the Commissioner.

The Board of Tax Appeals decided that these cancellations were not gifts under Section 22(b)(3). It was said:

"No evidence was introduced to show a donative intent upon the part of any creditor. The evidence indicates, on the contrary, that the creditors acted for purely business reasons and did not forgive the debts for altruistic reasons or out of pure generosity." 44 B. T. A. 425, 428.

With this conclusion we cannot agree. We do not feel bound by the finding of the Board because it reached its conclusions, in our opinion, upon an application of erroneous legal standards. Section 22(b)(3) exempts gifts. This does not leave The Tax Court of the United States free to determine at will or upon evidence and without judicial review the tests to be applied to facts to determine whether the result is or is not a gift. The fact that the motives leading to the cancellations were those of business or even selfish, if it be true, is not significant. The forgiveness was gratuitous, a release of something to the debtor for nothing, and sufficient to make the cancellation here gifts within the statute.

Affirmed.

Mr. Justice Rutledge took no part in the consideration or decision of this case.

SUPREME COURT OF THE UNITED STATES.

No. 303.—October Term, 1942.

Guy T. Helvering, Commissioner of Internal Revenue, Petitioner, *vs.* American Dental Co.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Seventh Circuit.

[March 1, 1943.]

Mr. Justice Frankfurter, dissenting.

When Congress wished to exempt income "attributable to the discharge . . . of any indebtedness" it did so explicitly. It defined such exemption with particularity and only to a limited extent, as illustrated by the various enactments, including § 114 of the Revenue Act of 1942, all of which appear to throw light leading away from and not towards the conclusion drawn from them by the Court. In the absence of such specific exemption of what as a practical matter may be income, determination of whether it is or is not income should be left to the tribunal whose special business it is to ascertain the controverted facts and the reasonable inferences from them. In deciding that, in the circumstances of the present case, the debt cancellations were not gifts and therefore taxable, the Board of Tax Appeals (now the Tax Court of the United States) did not invoke wrong legal standards. It knew well enough the difference between taxable income and gifts. It applied these legal concepts to its interpretation of the facts. That its judgment should not be upset is counselled by wise fiscal as well as judicial administration.

Mr. Justice Jackson joins in this dissent.